GAO

Report to Congressional Committees

DEFENSE CONTRACTOR RESTRUCTURING

First Application of Cost and Savings Regulations

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GAO

United States
General Accounting Office
Washington, D.C. 20548

National Security and
International Affairs Division

Defense Contractor Restructuring First Application of Cost and Savings Regulations

B-270798

April 10, 1996

The Honorable Strom Thurmond
Chairman
The Honorable Sam Nunn
Ranking Minority Member
Committee on Armed Services
United States Senate

The Honorable Floyd Spence
Chairman
The Honorable Ronald V. Dellums
Ranking Minority Member
Committee on National Security
House of Representatives

Section 818 of the National Defense Authorization Act for Fiscal Year 1995 (P.L. 103-337) restricts Department of Defense (DOD) payments to contractors for costs associated with business combinations. Specifically, it prohibits the payment of restructuring costs, such as those associated with closing facilities and eliminating jobs, until a senior DOD official certifies that projected savings from the restructuring are based on audited data and should result in overall reduced costs to DOD. In response to section 818 requirements, DOD issued interim regulations on restructuring costs effective December 29, 1994.

In accordance with section 818 requirements, we reviewed the implementation of DOD's restructuring regulations.[1] Our review sought to determine whether the certification process was carried out in accordance with the interim regulations and whether restructuring had resulted in lower DOD contract prices. We focused on the United Defense, Limited Partnership business combination between FMC Corporation's Defense Systems Group and Harsco Corporation's BMY-Combat Systems Division—two manufacturers of tracked combat vehicles for the Army. United Defense had the first and only restructuring proposal certified as of May 1995, when we started our review. This business combination is particularly significant because the implementation of DOD's restructuring regulations at United Defense could be a model for future restructuring efforts. The Defense Contract Management Command (DCMC), which has lead responsibility for implementing DOD's restructuring regulations, is

[1]As also required by section 818, we previously reported on the adequacy of DOD's interim restructuring regulations in Defense Restructuring Costs: Payment Regulations Are Inconsistent With Legislation (GAO/NSIAD-95-106, Aug. 10, 1995).

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currently tracking 30 business combinations, 7 of which involve over $450 million in audited restructuring costs and about $1 billion in audited restructuring savings over a 5-year period.

To protect proprietary data, we do not disclose specific dollar amounts applicable to any aspect of the United Defense restructuring.

Results in Brief

DOD's actions in reviewing and certifying the United Defense combination generally complied with the interim restructuring regulations. As required, the Defense Contract Audit Agency (DCAA) reviewed United Defense's restructuring proposal, and in May 1995, a senior DOD official certified that the restructuring should result in overall reduced costs. However, the projected net cost reduction certified by DOD represents less than 15 percent of the savings FMC and Harsco projected to DOD 2 years earlier when they sought support for the proposed partnership.

Subsequent to restructuring, DOD awarded United Defense a major contract to remanufacture combat vehicles at a price less than the price charged prior to restructuring. Company officials believe that most of the savings resulted from the restructuring.

Background

DOD's procurement funding for tracked combat vehicles declined by 86 percent between 1983 and 1994. In response, FMC Corporation and Harsco Corporation combined portions of their operations to form a limited partnership that became effective in January 1994. The United Defense partnership created one of the largest U.S. manufacturers of armored tracked combat vehicles.

To eliminate excess capacity and staffing resulting from the partnership, United Defense began restructuring its operations by combining two divisions—the California-based Ground Systems Division, previously part of FMC, and the Pennsylvania-based Combat Systems Division, previously part of Harsco-BMY. United Defense is moving the final assembly and test of most product lines from California to Pennsylvania. According to United Defense, the majority of the restructuring costs are the result of this move. The company is also consolidating redundant staff functions, such as finance and human resources.

DOD Actions Generally Complied With Regulations

Our review indicates that DOD's actions in approving payment of restructuring costs for the United Defense combination generally complied with the interim restructuring regulations, three major elements of which are submission of a restructuring proposal, audit of that proposal, and certification of net benefit. United Defense submitted the required restructuring proposal on January 3, 1995. The contractor's proposed savings were based entirely on workforce reductions. DCAA reviewed the contractor's proposal and questioned a small portion of the costs and savings. United Defense subsequently agreed to reduce its proposed costs and savings by the questioned amounts.

In its audit report, DCAA pointed out that the regulations require the Administrative Contracting Officer (ACO)[2] to immediately adjust overhead rates upon submission of a restructuring proposal to ensure that DOD benefits from savings projected. The ACO instead required United Defense to submit updated rates upon negotiation of the restructuring proposal. Since United Defense was not awarded any major firm fixed-price[3] contracts before it updated the rates, DOD was not adversely impacted by this delay. However in future restructuring efforts, such actions could place the government at risk, if contracts are awarded without a downward price adjustment clause before rates are updated.

On May 15, 1995, the Under Secretary of Defense (Acquisition and Technology) certified that projections of future cost savings were based on audited cost data and should result in overall reduced cost to DOD. Under this projection, for every dollar in costs, DOD should realize $2.49 in total savings, or $1.49 in net savings.

Lower Savings Than Originally Projected

Projected net savings at the time of DOD certification represent less than 15 percent of the estimate FMC and Harsco originally presented to DOD. In late 1992, the companies requested Army financial support for the proposed partnership, in terms of sharing the costs of restructuring, as the Army stood to benefit from the partnership. According to FMC, the consolidation of manufacturing and overhead functions would lower the Army's product costs. The companies projected that every dollar in restructuring costs would generate over $10.00 in net savings. To put this

[2]The ACO is responsible for day-to-day contract administration functions, such as determining the allowability of contract costs and negotiating overhead rates with the contractor, subsequent to the award of a contract.

[3]Under firm fixed-price contracts, the contractor agrees to furnish supplies or services at a specified price that is not subject to adjustment based on costs incurred.

projection into perspective, the Deputy Secretary of Defense advised a congressional subcommittee in mid-1994 that based on rough data estimated projected savings for four restructurings at that time ranged from one and a half to seven times the projected cost. Later in these hearings, however, the Deputy Secretary told the subcommittee that future restructuring savings could range from four to seven times the projected cost. In other words, for every dollar DOD invests in restructuring costs, it could realize savings from $1.50 to $7.00.

Several factors account for the difference between the original savings estimate of $10.00 and the current estimate of $1.49. For example, the initial estimate was based on reductions in specific elements of cost, including overhead, manufacturing, and material. In addition, the initial estimate included savings from improved facility utilization resulting from potential increases in foreign sales. However, because section 818 and DOD's implementing regulations only required that United Defense demonstrate that restructuring should result in reduced costs, United Defense chose to base its current estimate solely on elements of cost related to workforce reductions. Also, the initial estimate was spread over an 8-year period and was adjusted for inflation, while the current estimate was spread over 5 years and was not adjusted for inflation. DCMC and DCAA guidance issued subsequent to the initial estimate indicated that savings should be calculated over a 5-year period. In addition, the initial estimate was considered a rough-order-of-magnitude, according to DOD officials.

Restructuring Contributed to a Reduction in Unit Price

At the time of our review, DOD had awarded United Defense only one new contract that was comparable to a contract awarded prior to restructuring. In that one contract, United Defense's restructuring efforts did contribute to a reduction in the unit price, but the precise amount of savings resulting from restructuring cannot be determined. U.S. Army Tank-Automotive and Armaments Command (TACOM) officials compared the negotiated unit price of that one contract, a follow-on remanufacturing contract that included the effects of restructuring, to the unit price of the initial contract that did not include the effects of restructuring. According to TACOM officials, the unit price of the follow-on contract was 11 percent lower than the initial contract price, not adjusted for inflation. TACOM's analysis was based on the basic contract for 172 vehicles. According to United Defense officials, the follow-on unit price was 16 percent lower, adjusted for inflation. United Defense's analysis was based on the basic contract plus options, for a total of 272 vehicles.

Our analysis indicated that savings could range from 8 to 16 percent. The range of savings in these three sets of estimates is due primarily to differences in estimates of the number of units to be remanufactured and the inflation rate used to adjust the unit price of the initial contract. The 8-percent savings estimate was based on the basic contract and not adjusted for inflation, as with TACOM's estimate. The 16 percent savings was based on the inflation rate United Defense used in its analysis—approximately 2.6 percent per year over a 2-year period—and the basic contract plus the options.

TACOM officials believe that the reduction in unit price was due to both restructuring and downsizing, which would have occurred absent the restructuring. United Defense officials believe that the vast majority of the savings was due to lower costs resulting from restructuring. Nevertheless, our analysis illustrates the sensitivity of the projected savings to the inflation rate and the number of vehicles purchased.

Agency Comments

In commenting on a draft of this report, DOD concurred with the report. DOD suggested two technical clarifications and we have incorporated them in the text where appropriate. DOD's comments are presented in their entirety in appendix I.

Scope and Methodology

To assess DOD's compliance with the interim restructuring regulations, we analyzed United Defense's restructuring proposal, the DCAA audit report on that proposal, and other documents. We also discussed restructuring activities with officials from United Defense, DCMC, DCAA, TACOM, and offices of the Director of Defense Procurement, the Secretary of the Army, and the DOD Inspector General. In addition, we examined information on overhead rates, business volumes, and unit prices at two United Defense plant sites and at TACOM.

To determine the impact of restructuring on DOD contract prices, we examined all contracts awarded after restructuring that were potentially comparable to those awarded prior to restructuring. We calculated the unit price of the only comparable contract, which did not include the effects of restructuring, and compared it to the unit price of the only similar contract that included the effects of restructuring. Furthermore, we evaluated similar calculations and comparisons made by United Defense and TACOM officials to determine the bases for differences in estimates of savings.

We performed our review between May 1995 and January 1996 in accordance with generally accepted government auditing standards.

We are sending copies of this report to the Chairmen of the Senate Committee on Governmental Affairs, the House Committee on Government Reform and Oversight, and the House and Senate Committees on Appropriations and on the Budget; the Secretaries of Defense and the Army; the Commander, DCMC; the Director, DCAA; and the Chief Executive Officer, United Defense. We will also provide copies to others upon request.

Please contact me at (202) 512-4587 if you or your staff have any questions concerning this report. The major contributors to this report were John K. Harper, George C. Burdette, Anne-Marie Olson, and Kelly A. Davis.

David E. Cooper
Associate Director, Defense Acquisitions Issues

Comments From the Department of Defense

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ACQUISITION AND TECHNOLOGY

MARCH 1, 1996

DP/CPF

Mr. Louis J. Rodrigues
Director, Defense Acquisitions Issues
National Security and International
Affairs Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Rodrigues:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) Draft Report GAO/NSIAD-96-80 "DEFENSE INDUSTRY RESTRUCTURING: First Application of Cost and Savings Regulations," Dated February 13, 1996 (GAO Code 705104, OSD Case 1083).

The DoD concurs with the report, with the following two exceptions. The first paragraph of the "Lower Savings Than Originally Projected" portion of the report states that the Deputy Secretary of Defense advised a congressional subcommittee in mid-1994 that he estimated projected savings from defense industry restructuring in general could range from four to seven times the projected cost. This statement is not accurate. According to the official opening statement dated July 27, 1994, the Deputy Secretary of Defense said "Based on the rough data we have seen so far in four restructurings occurring after an acquisition or merger, the projected savings range from one and a half to seven times the projected costs" (emphasis added). In other words, for every dollar DoD invests in restructuring costs, it could realize savings from $1.50 to $7.00. When compared to the Deputy Secretary's official statement, the reported estimated net savings of $1.49 for every dollar DoD invests in restructuring costs resulting from the United Defense business combination essentially falls within the range of anticipated savings.

The first paragraph of the "Restructuring Contributed To A Reduction In Unit Price" portion of the report states that the GAO analysis indicated that savings on a new follow-on contract awarded to United Defense subsequent to the restructuring could range from 8 to 15 percent, depending on the estimated number of units to be remanufactured and the inflation rate used to adjust the unit price of the initial contract. It appears that the lower end of the estimated range of savings of 8 percent is based

on a zero inflation rate. This does not appear to be a reasonable assumption; using a minimal inflation rate such as 3 percent would be more equitable. In addition, it would be helpful if the inflation rate used by GAO to compute the estimated range of savings was included in the report.

Sincerely,

Eleanor Spector

Eleanor R. Spector
Director, Defense Procurement